Office of Gas and Electricity Markets (OFGEM)
FAO: Dale Winch
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

17 January 2022

Dear Dale,

Statutory Consultation on modifications to the RIIO-2 Transmission, Gas Distribution and Electricity System Operator Licence Conditions.

I am pleased to enclose a response from SSEN Transmission[1] to Ofgem's consultation on the above publication. As requested by Ofgem, an attached issues log provides the detailed response to the consultation. This letter forms a supporting document only to that issues log, providing more detailed feedback on NARMs; the Network Asset Risk Metric (NARM) licence modifications, the introduction of the NARM Handbook and the Network Asset Risk.

Broadly, we welcome and support the CMA outcome and directed amendments in setting out changes proposed to our licence conditions to implement the CMA's Order following RIIO-2 appeals but there remain issues that need to be addressed to fully implement the CMA's Order, along with the proposed wider licence changes. We draw particular attention to the following:

- Ofgem has not set out the nature and parameters of such future modification in relation to Special Condition 9.3 (Price Control Deliverable assessment principles and reporting requirements). For example, in relation to Part A (specifically in relation to 9.3.3(a) and (d)), it is not immediately clear to SSEN Transmission what happens in the event Ofgem decides to make an adjustment to allowances (or the assessment Ofgem would then apply in making a judgement as to the amount of any reduction). The lack of specificity does not enable the licensee to understand its potential scope and proposed amendments to allowances should therefore be subject to the Statutory Licence Modification Process (SLMP)
- We also continue to disagree with the use of an overly simplistic pro rata formula to determine the reduction in allowances associated with Partial Delivery under Special Condition 9.3 (Price Control Deliverable assessment principles and reporting requirements). Ofgem has implicitly accepted that the unit costs associated with delivery of infrastructure are not linear (by the very nature of ex-post evaluation) and we are therefore unclear as to why Ofgem has taken a different approach in respect of Partially Delivered PCDs. Again, we consider any amendments to allowances should be subject to the SLMP.
- We disagree with the use of the Materiality Threshold under Special Condition 8.1 (Governance of the ET2 Price Control Financial Instruments). Whilst we support the clarity Ofgem has provided via paragraph 8.1.5 (listing those amendments that will improve the functionality or clarity) we disagree with Ofgem's position that it can direct amendments to the to the ET2 Price Control Financial Instruments where the impact is below the Materiality Threshold. The Materiality Threshold was never

[1] References to SSEN Transmission encompass the licenced entity Scottish Hydro Electric Transmission plc Registered in Scotland No. SC213461.

designed as a threshold against which Ofgem would measure the potential impact of proposed amendments on licensees (rather it was designed to reduce the burden on Ofgem in relation to re-openers). For SSEN Transmission, the value of the Materiality Threshold per annum across RIIO-T2 could amount to c.£35m. We consider this be of significant value with no right to challenge should we disagree with Ofgem's approach. We also note Ofgem's intention not to present 'manifest errors' to the ET2 Price Control Financial Model Working Group and assume this has no impact on allowed revenue. We disagree with this approach for the reasons set out above and believe special condition 8.1.6 must be amended to incorporate paragraphs 8.1.5(a) to (e) and remove any reference to Materiality Threshold as part of condition 8.1.3.

- In relation to Special Condition 3.1 Baseline Network Risk Outputs (BNRO) we are concerned Ofgem has introduced an absolute requirement to deliver BNRO.
  - *"3.1.2 The purpose of this condition is to: (a)* ***require*** *the licensee to deliver Baseline Network Risk Outputs;"* and
  - *"3.1.6 The licensee* ***must*** *by the end of the Price Control Period, deliver its Baseline Network Risk Outputs as set out in Appendix 1"*
  - Given the interactions with load-related investments and the complexity associated with NARMs, this leads to an increasingly challenging position for transmission owners. In our view, this should be drafted consistent with other Price Control Deliverables whereby the licensee is funded to deliver an outcome with the adjustment calculation set out elsewhere (which appears to be Ofgem's intent as demonstrated through 3.1.7 which sets out funding adjustments and penalties). It is unclear why Ofgem has introduced an absolute requirement to deliver (additional risk of enforcement action) and also set out a funding adjustment calculation within the NARM Handbook (which will also carry the same status as the licence). This could potentially amount to double jeopardy in the event a licensee fails to deliver BNRO.

We largely agree with the proposed modifications to the NARM Handbook and the Network Asset Risk Workbooks that will facilitate a statutory licence modification process (SLMP). We have however expanded on our concerns with NARMS more generally below.

General NARM Concerns

NARM has been developed in RIIO-2, building on the NOMs monetised risk approach developed in the latter years of RIIO-1. It is the primary measure for defining our non-load core asset interventions outputs. However, as we have outlined previously, the NARM mechanism is still immature and not wholly fit for purpose. We see this demonstrated by multiple network companies having to ring-fence certain asset management activities to be dealt with outside of the NARM mechanism.

The current flaws of the mechanism can best be demonstrated using an example from our RIIO-T2 Outputs. One scheme (Harris – Stornoway OHL scheme) represents 72% (R£6,319m out of R£8,833m) of our target risk reduction over five years. However, this project only represents 5% (£36.62m) of our £752m baseline funding provided to remove and reduce asset risk through replacement and refurbishment across our extensive network. This illustrates a flaw of the Monetised Risk and NARM methodology which has not adequately been considered thus far i.e., Monetised Risk, as currently developed, does not reflect the real world.

Due to the individual configuration of the Transmission networks across Great Britain some asset interventions generate large monetised risk benefits for a relatively low cost, such as radial OHL circuits in the example above. Conversely, there are other asset management schemes which generate a relatively low monetised risk output but require significant investment to remedy the underlying condition issues.

This gives rise to four major concerns for network companies and the consumer.

1. **Need** If the NARM is given primacy by Ofgem to evidence need, then this could drive Network Companies to make the wrong decisions for fear of regulatory penalties or inability to recover legitimate costs, resulting in interventions being taken that may not be in the interest of the consumers. Monetised risk alone can never be used to demonstrate the need for an asset intervention, nor should it be given primacy over other indicators. It can be used as part of a much wider toolbox of indicators to demonstrate and evidence asset interventions. However, robust asset stewardship of our networks, based on understanding of the condition of individual and groups of assets, is required to target investment and delivery where it is required.
2. **Incentive -** Regulatory incentives should be designed to drive the right behaviour, yet network companies are actually incentivised by Ofgem's NARM mechanism to intervene on schemes which generate a large monetised risk benefit but with a relatively low cost, regardless of the actual need for intervention on that particular part of the network. Currently, the incentive in terms of output delivery would be to repeatedly intervene on our OHL radial circuits due to the large monetised risk which is generated by interventions on this part of the network. We could deliver the price control outputs but not address a growing risk issue on the core of our net zero network. This could also act as a disincentive to address an emerging asset condition issue which has a relatively low R£ value but a higher cost.
3. **Mechanistic adjustment -** The NARM Funding Adjustment mechanism is fundamentally flawed. As we have illustrated below, and in previous evidence provided, the Unit Cost of Risk Benefit (UCRB) approach simply does not work for our project-based approach to Non-Load investment. Therefore, the UCR Funding Adjustment Mechanism is rendered unfit and the outputs unfair for us or our consumers.
4. **Inappropriate gains / losses -** The illustration below demonstrates that trade-offs or substitutions could lead to a risk of windfall gains or losses in RIIO-2. Due to the flaws with the NARM Funding Adjustment mechanisms, Network Companies could potentially benefit or be penalised by windfall gains and losses by undertaking trade-offs from the schemes included within its Business Plan. This was never the purpose of developing a common unit of measurement by which different asset intervention decisions could be compared.

Points 3 and 4 have been acknowledged to some extent by Ofgem by the introduction of Risk subcategories and "Clearly Identifiable Projects" where Ofgem will assess projects on a project-by-project assessment in exceptional circumstances. However, unless Ofgem treats every asset trade-off or substitution in this manner, then the risk of unexpected and unwarranted outcomes remains. These additions add to the overall complexity without addressing the underlying problems.

NARM Handbook

The NARM Handbook and the NARM Funding Adjustment and Penalty Mechanism set out a framework for TOs to clearly quantify the benefits of their asset management activities. The NARM methodology has developed into an unnecessarily complex mechanism that doesn't facilitate asset project substitutions easily.

We are concerned that Ofgem's NARM Funding Adjustment Mechanism will not work for our project-based approach to Non-Load.

A real-world example where the NARM Funding Adjustment and Penalty Mechanism does not work, and is exhibiting unintended outcomes, is the Broadford Substation asset replacement works which is part of our RIIO-T2 plan. The project includes the asset interventions at the Broadford Substation due to the poor condition of certain assets and the risk to network security and reliability that they posed. However, the Skye OHL Reinforcement Project load driver has come along facilitating the requirement for reinforcement at Broadford Substation.

North of Scotland
0800 300 999
Central Southern England
0800 072 7282

Should the Load-related Broadford GSP Reinforcement Project proceed, then full scope of works for the Non-Load Broadford Substations works are no longer required, as the reconfiguration of the site will replace the assets in poor condition and will ensure that all the non-load scope is included generating efficiencies across the board.
Applying the Funding adjustment mechanism to the non-delivery of the Broadford Non-Load works would remove £25.21m from the RIIO-T2 NARM Allowance, the allowance for Broadford was only £2.56m in the first place. It can be seen that the funding and adjustment mechanism is not working in this instance and that the outputs are clearly flawed. The only way to obtain a sensible outcome is for this scheme to be considered as clearly identifiable under delivery project.

We acknowledge that this is why Ofgem introduced the "Clearly Identifiable Over-Delivery or Under-Delivery", however we believe that this process has to be used for all of our changes to the T2 plan and not just in "in rare cases where a small number of projects are clearly identifiable as driving an Over-Delivery or Under-Delivery".

Also, part of the criteria for Clearly Identifiable projects remains undefined, this is the upper and lower threshold for clearly identifiable under/over delivery, and this should have already been defined upfront in the T2 price control. For SSEN Transmission, 70% of our schemes have an actual UCRB which is +/- 50% different to the NARMW Baseline UCRB. Again, this demonstrates the clear flaws with the NARM mechanism, and that it is highly likely that any deviations to plan will fall into the clearly identifiable mechanism. Clearly there is something wrong if the mechanism designed to catch outliers is actually required for most scenarios.

Having raised our concerns that the NARM mechanism is not yet fully fit for purpose, rather than bolting on further complicated mechanisms to try to address the fundamental flaws of the mechanism, it is something that would benefit from a policy change early in T2. It is our learning from the T1 close-out that has come to the fore and had this process been completed earlier, we would have taken this learning to the T2 policy framework.

Network Asset Risk Workbooks (NARW)

We agree that the Network Asset Risk Workbooks (NARW) aligns with the Baseline Network Risk Outputs and Risk Sub-Category. However, we note that the allowances set out in the NARW are inconsistent with the licence condition SpC 3.1. We strongly urge Ofgem to align any allowances with the licence conditions and the PAM.

As outlined in our response to the Ofgem statutory consultation on its proposal to modify the Standard and Special Conditions of the electricity transmission licence, we cannot reconcile the Baseline Allowed NARM Expenditure as contained in Appendix 1 of SpC 3.1, and this is the same for the allowances within the NARW. We believe that it is essential that Ofgem ensures that any allowances set out in the NARW should be consistent with the Project Assessment Model and associated models.

If you have any questions regarding the information provided in this response or the issues raised in the associated issues log then please do not hesitate to get in touch.

Yours sincerely,

Steven Findlay
Senior Regulation Manager
SSEN Transmission